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Macroeconomic policy questions**International financial system and development****Report of the Secretary-General*****Summary*

The present report, submitted pursuant to General Assembly resolution 72/203, summarizes ongoing efforts to implement the commitments and actions contained in the Addis Ababa Action Agenda of the Third International Conference on Financing for Development with regard to the international financial and monetary architecture, financial regulation, development finance institutions and governance reform. The report contains two main sections. The first examines trends in international private and public capital flows to developing countries, while the second focuses on strengthening the international financial architecture in support of the 2030 Agenda for Sustainable Development.

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** The present report was prepared with input from the major institutional stakeholders involved in the financing for development process. Responsibility for its contents, however, rests solely with the United Nations.



I. Introduction

1. In its resolution 72/203, the General Assembly recognized the need to continue to enhance the coherence and consistency of the international monetary, financial and trading systems, and to ensure their openness, fairness and inclusiveness. It also encouraged the international financial institutions to align their programmes and policies with the 2030 Agenda for Sustainable Development and emphasized the critical importance of a stable global economic environment for achieving the Sustainable Development Goals.

2. An effective and stable financial system is necessary for the allocation of resources to address sustainable development needs. Since the global financial crisis, the implementation of financial sector reforms has helped to reduce some important risks in the financial system. At the same time, other systemic risks have risen, particularly in areas outside the regulatory framework, including cross-border capital flows, certain types of shadow banking and debt. There are various causes for this, including monetary tightening, rising trade tensions and uncertainty surrounding the future of multilateral cooperation. According to the Addis Ababa Action Agenda of the Third International Conference on Financing for Development, regulatory gaps and misaligned incentives continue to pose risks to financial stability, including risks of spillover effects of financial crises to developing countries, which suggests a need to pursue further reforms of the international financial and monetary system. Three years after the adoption of the Addis Ababa Action Agenda, challenges to the international monetary system persist.¹ In the medium to long term, shifts in the international monetary system, including those related to external adjustment and global reserve accumulation, could create additional financial volatility, underscoring the importance of strengthened international cooperation, including with regard to macroeconomic policymaking.

3. There has also been progress on addressing some non-financial environmental, social and governance risks, particularly with respect to climate change. However, while there is growing interest in sustainable investing, the international financial system is not yet adequately aligned with sustainable development, and there is insufficient investment in a range of critical areas, such as infrastructure, small and medium-sized enterprises and clean technologies. Policy choices play an important role in this regard, particularly as policies, such as financial market regulations, taxes and subsidies, can have unintended consequences and incentivize behaviour that is not necessarily supportive of the Sustainable Development Goals.

4. To achieve the Sustainable Development Goals, the global financial system will need to allocate long-term public and private resources for sustainable development in an effective and stable manner. Ultimately, stability and sustainability are mutually reinforcing: social, environmental and economic sustainability supports long-term stability, while without a stable financial system, achieving the Goals risks being derailed by future financial crises.

II. Trends in economic growth and capital flows

5. In its mid-year update of the world economic situation and prospects for 2018 (E/2018/63), the Economic and Social Council forecast that world gross product will expand by 3.2 per cent in 2018 and 2019. However, some countries and regions are not sharing in this global cyclical upturn. For example, in per capita terms, output is

¹ <https://www.imf.org/en/News/Articles/2018/04/11/pr18126-imf-executive-board-discusses-the-role-of-sdr>.

expected to decline in Central and in Southern Africa. While 40 per cent of countries had their growth forecasts revised upward in the mid-year update, 25 per cent of countries had them revised downward.

6. At the same time, risks to the economic outlook have been growing. Trade tensions between major economies and associated spillover, monetary policy adjustment in developed countries, elevated debt levels and an increase in geopolitical tensions could derail progress. In the past year, global financial markets have demonstrated significant instability, with exchange rate volatility intensifying in the second quarter of 2018 in a number of developing countries, driven in part by changing monetary policy in systemically important countries, as well as country-specific risks.

7. In aggregate, developing countries recorded capital outflows of \$255 billion in 2017, following outflows of \$431.5 billion in 2016.² The lower level of capital outflows in 2017 largely reflects flows to China, which moved from a position of large net outflows in 2015 and 2016 to net inflows of \$148 billion in 2017.³

A. Private flows

8. Private capital flows have three main components: foreign direct investment (FDI), portfolio flows and other investment. FDI is generally the most stable of these and, as noted in the Addis Ababa Action Agenda, can make an important contribution to sustainable development, particularly when projects are aligned with sustainable development strategies. The United Nations Conference on Trade and Development (UNCTAD) estimates that global FDI fell by 23 per cent in 2017, to an estimated \$1.43 trillion, with most of the decline in developed countries in Europe and North America. While FDI flows to developing economies remained stable at \$671 billion, this followed a 10 per cent drop in 2016. Flows to Africa continued to slide, falling 21 per cent to \$42 billion in 2017, with the decline concentrated in the larger commodity exporters. FDI to the least developed countries declined to \$26 billion, representing a reduction of 17 per cent. Overall, projections for 2018 are for only fragile growth in FDI.⁴

9. Net portfolio flows to developing countries, which are driven primarily by institutional investors, remained volatile. They recovered from earlier outflows to reach \$163 billion, driven by the recovery in flows to China. However, this was counterbalanced by net outflows of \$136 billion in the "other investment" category, primarily cross-border bank loans.⁵ Regionally, emerging and developing Asia saw inflows in cross-border bank loans, although this is projected to reverse in 2018.⁶ Latin America and the Caribbean saw a nearly 2 per cent year-on-year decline in cross-border bank exposure in mid-2017, although this recovered in the second half of the year.⁷

² International Monetary Fund (IMF), *World Economic Outlook: April 2018* (Washington, D.C., 2018), table A13.

³ www.safe.gov.cn/wps/wcm/connect/6d920c804c296c90a415af4393d9cc2e/The_time-series_data_of_Balance_of_Payments_of_China.xlsx?MOD=AJPERES&CACHEID=6d920c804c296c90a415af4393d9cc2e

⁴ UNCTAD, *World Investment Report* (Geneva, 2018).

⁵ Other investment includes currency and deposits, loans, trade credits and other financial sector instruments.

⁶ IMF, *World Economic Outlook: April 2018* (Washington, D.C., 2018), table A13.

⁷ www.bis.org/statistics/rppb1804.pdf and stats.bis.org/statx/srs/tseries/LBS_D_PUB/Q.F.C.A.TOI.A.5J.A.5A.A.5R.N?i=A6.2&c=5R&m=F&p=20174&x=L_MEASURE.LCL_STOCK_FLOW&o=s.stc.z.0

10. These aggregate figures do not capture the daily volatility, nor do they reflect the market volatility that hit a number of emerging market currencies in the first half of 2018, when the Brazilian real, the Turkish lira and the Argentinian peso fell 17, 29 and 56 per cent respectively. These devaluations put upward pressure on the prices of imported goods and commodities, as well as on the cost of external debt servicing. The increased yield on short-term United States of America Treasury bills, with three-month yields rising above 2 per cent for the first time since the financial crisis, contributed to the rapid currency depreciations, with exchange rate pressure more acute in countries with weaker fundamentals or higher political risk.

11. Debt risks and vulnerabilities in both developing and developed countries also continue to increase, as global interest rates rise. For low- and middle-income countries, the ratios of external debt to gross domestic product (GDP) have been rising since the world financial and economic crisis of 2008, with a weighted average of 26.8 per cent and a median of 40 per cent in 2017. Average debt-to-GDP ratios in small island developing States have reached 42.9 per cent, with a quarter having ratios above 70 per cent. The International Monetary Fund (IMF) and the World Bank have judged that 18 low-income developing countries are at high risk of entering or have already entered a state of debt distress. As of the end of 2017, 8 countries had seen their rating downgraded relative to 2013, with only 3 upgrades.

12. The creditor landscape has also changed, with increasing prominence of non-Paris Club bilateral and plurilateral creditors. Between 2015 and 2016, South-South cooperation drove new bilateral loan commitments to low- and middle-income countries to more than double, to \$84 billion. In many cases, the share of lending by non-Paris Club creditors in total external debt exceeds the share of Paris Club and traditional multilateral creditors. In addition, the share of private creditors in public and publicly guaranteed external debt rose from 41 per cent to 61 per cent in developing countries overall, and from 8 per cent to 16 per cent in least developed countries. Such shifts present challenges for traditional mechanisms for debt workouts and underscore the need to re-examine creditor cooperation mechanisms.

13. Improving capacities to monitor and analyse public and private debt will require better and broader data collection. Effective sovereign debt management requires full information on the terms and conditions of debt, contingent liabilities and domestic arrears. Private sector debt also needs to be monitored carefully, as the manifestation of systemic risk in financial crises can result in debt burdens being transferred from private to public balance sheets. Public sector creditors have a role to play by making the terms and conditions of lending straightforward and easy to track.

B. International public finance institutions

14. Public finance provides important contributions to efforts to achieve the Sustainable Development Goals. Public international financial flows are much smaller than their private counterparts, but the comparison is misleading, as the funds are often used for investment in public goods, which would not be attractive to private investors.

15. In 2016, annual disbursements of non-grant subsidized finance from seven traditional multilateral development banks reached \$65.8 billion, an increase of 15 per cent over 2015. The New Development Bank and the Asian Infrastructure Investment Bank both completed their second full year of operations in 2017. The Asian Infrastructure Investment Bank committed \$2.5 billion to 15 projects,⁸ while

⁸ Asian Infrastructure Investment Bank, *2017 Annual Report and Financials* (2018, Beijing)

the New Development Bank committed \$2.1 billion to 7 projects.⁹ In addition, shareholders recently increased their paid-in capital in some multilateral development banks. In April 2018, World Bank Group shareholders agreed in principle to a \$13 billion paid-in capital increase, with \$5.5 billion designated for the Bank's public-sector non-grant subsidized arm and the remainder for private sector lending from the International Finance Corporation.¹⁰ The new capital will allow the World Bank Group to increase annual lending to \$100 billion by 2030, compared to \$59 billion in 2017. In May 2018, African Development Bank shareholders also authorized discussions on a capital increase.¹¹

16. IMF, which provides lending for balance of payments support, approved \$91 billion of new non-concessional commitments in the fiscal year 2018, including concessional loans of \$2.1 billion to its low-income developing members.¹²

III. Strengthening the international financial system

A. International financial and monetary architecture

International monetary system and financial safety nets

17. A large proportion of global savings is currently held as international reserves by central banks. Many developing countries built up international reserves as a form of self-insurance against capital flow and exchange rate volatility. Although reserve accumulation has slowed in recent years, from 2000 to 2017 foreign exchange reserves increased from \$2.0 trillion to \$11.8 trillion, with approximately \$7.0 trillion held by developing countries. In 2017, developing country reserves grew by \$165 billion, following a fall of \$482 billion in 2016, in large part in response to changes in capital flows to China. IMF predicts moderate growth of reserves in developing and transition countries in 2018 and 2019.

18. The accumulation of reserves has been successful in dampening exchange rate volatility. For example, China was able to use reserves to limit exchange rate movements in response to capital outflows in 2016. However, many developing countries lack the capacity to build large stocks of reserves, making them more vulnerable to volatility in international markets. In addition, the accumulation of international reserves in safe low-yielding assets has an opportunity cost. Reserves are mostly invested in United States Treasury bills and bonds, implying that developing country resources are lent back to developed countries at relatively low interest rates. Rather than accumulating reserves, resources could instead be invested in domestic productive capacity, infrastructure or other projects related to the Sustainable Development Goals.

19. The share of international reserves held in United States dollars has been falling steadily. United States dollar-denominated reserves currently account for 62.5 per cent of the total, down from a peak of 71.5 per cent in 2001, a relatively constant decline through the financial crisis and other economic events.¹³ Euro-denominated assets account for 20.4 per cent, while Chinese renminbi-denominated assets, which were reported for the first time in 2016, account for 1.4 per cent of the total.¹⁴ The

⁹ www.ndb.int/projects/list-of-all-projects/

¹⁰ www.worldbank.org/en/news/press-release/2018/04/21/world-bank-group-shareholders-endorse-transformative-capital-package

¹¹ am.afdb.org/sites/default/files/am_2018_final_communique_busan.pdf

¹² www.imf.org/external/np/fin/tad/extarr11.aspx?memberKey1=ZZZZ&date1key=2018-06-30

¹³ Other events include the 2011 downgrade of the United States sovereign credit rating and various changes to the United States debt ceiling.

¹⁴ www.imf.org/external/np/sta/cofer/eng/index.htm

decline in the share of reserves held in United States dollars is seen by some economists as the beginning of a shift from the current primarily United States dollar-based system to a multi-currency reserve system. There is a risk that such a system could lead to more volatility, owing to greater uncertainty and fluctuations across several major reserve currencies. Weak macroeconomic coordination across systemically important economies could exacerbate this volatility. The potential for greater risks to developing countries and their progress towards the Sustainable Development Goals underscores the importance of strategies to align the international monetary system with the 2030 Agenda, such as global macroeconomic policy coordination and strengthened safety nets.

20. An IMF note prepared for the Group of 20 in 2016 outlined initial considerations for a global reserve system based on the special drawing right, an international reserve asset managed by IMF, or a similar non-national currency or reserve asset. In March 2018, the Executive Board of IMF discussed whether a broader role of the special drawing right could contribute to the smooth functioning and stability of the international monetary system. It was concluded that the special drawing right as a reserve asset had the greatest potential, albeit under a different legal framework that would require amendments to the IMF Articles of Agreement. However, the Executive Board was uncertain of the role for the special drawing right in addressing the weaknesses in the international monetary system and did not come to a consensus on that issue. It supported further analysis of how economic and technological transitions, such as a potential move towards a multipolar global economy and the adoption of financial technologies, could reshape the international monetary system in the future, while noting that the role of the special drawing right should not be the central question in such discussions.¹⁵

21. In the Addis Ababa Action Agenda, the Heads of State and Government and High Representatives recognized the need to strengthen the permanent international financial safety net, with a strong and quota-based IMF, and urged IMF to continue its efforts to provide more comprehensive and flexible financial responses to the needs of developing countries. The global financial safety net is a network of institutions and financing facilities that can provide liquidity to countries in times of financial stress. It comprises multilateral lending facilities primarily operated by IMF at a global level, regional facilities and bilateral lines of credit (frequently through reserve currency swap lines). The Inter-Agency Task Force on Financing for Development prepared an inventory of quick-disbursing international instruments, mapping the different components of the global financial safety net, as part of its 2018 report on financing for development.¹⁶ The mapping, which includes recent efforts, such as the May 2017 reforms of the IMF quick-disbursing instruments — the rapid credit facility and the rapid financing instrument — shows both the breadth of the global financial safety net and the gaps in coverage and coordination.

22. Additional options for reforming the global financial safety net could build on existing regional reserve pooling arrangements, such as the Chiang Mai Initiative Multilateralization. The pooling of reserves can help individual countries to overcome the challenge of limited resources. Synchronization among IMF, regional arrangements and other elements of the global financial safety net can help to bridge the gaps for the many countries, including some large emerging markets, that continue to lack adequate access to predictable and reliable funding. Improvements to the global financial safety net would be more effective if agreed in advance of crises rather than in the midst of them.

¹⁵ <https://www.imf.org/en/News/Articles/2018/04/11/pr18126-imf-executive-board-discusses-the-role-of-sdr>

¹⁶ developmentfinance.un.org/sites/developmentfinance.un.org/files/Report_IATF_2018.pdf

Aligning capital flows with sustainability and the Sustainable Development Goals

23. The quality of capital flows is crucial, as Member States need to maximize the benefits of inflows, while effectively managing the risks. The Addis Ababa Action Agenda recognizes that when dealing with risks from large and volatile capital flows, necessary macroeconomic policy adjustment could be supported by macroprudential and, as appropriate, capital flow management measures.

24. Macroprudential policies and measures, which are designed to limit systemic risk, encompass a wide variety of tools that can help to build buffers to shocks, mitigate the pro-cyclicality of financial markets and institutions, and limit the structural vulnerabilities in the financial system.¹⁷ A July 2017 IMF report on the effectiveness of macroprudential policies found that their effectiveness varies based on capital market openness, financial market development and the potential for domestic and cross-border leakage. According to the report, "source country policies can also play an important role in increasing global effectiveness of macroprudential policies in containing systemic risks from capital flows".¹⁸ Indeed, the 2030 Agenda emphasizes universality because it recognizes the interconnectedness of all countries. Yet, to date, international investor incentives are not designed to reduce systemic risks, as exemplified by many investors' short-term orientation.

25. There is increasing interest in the role of institutional investors in financing sustainable development, particularly those with long-term liabilities such as pension funds, life insurance companies and sovereign wealth funds, owing to their significant assets under management, at around \$80 trillion in assets as at the end of 2016.^{19,20,21} For pension funds, around 40 per cent of liabilities are distributed within 10 years, and 60 per cent within 20 years, implying that the potential size of portfolios that are well-suited for illiquid investments, such as infrastructure, is significantly less than the headline number, although even after adjustments, total long-term liabilities remain extremely large.²² However, many asset managers have short-term investment horizons, which is reflected in high turnover rates and in the volatility of cross-border portfolio flows. Most asset managers, even those with long-duration liabilities, generally invest in short-term and liquid assets. For example, in 2017, the pension funds in the seven largest pension markets allocated 75 per cent of their portfolios to liquid assets, overwhelmingly in developed countries, rather than long-term illiquid assets such as infrastructure.²³ One way to address the issue of lack of demand for illiquid assets is to try to repackage investments in a liquid form. This is behind the calls to develop infrastructure as an asset class. The expectation is that standardizing

¹⁷ Piet Clement, "The term 'macroprudential': origins and evolution", *BIS Quarterly Review*, March 2010. Available at http://www.bis.org/publ/qrpdf/r_qt1003h.pdf.

¹⁸ IMF, "Increasing resilience to large and volatile capital flows: the role of macroprudential policies", IMF Policy Paper (Washington, D.C. 2017). Available at www.imf.org/en/Publications/Policy-Papers/Issues/2017/07/05/pp060217-increasing-resilience-to-large-and-volatile-capital-flows.

¹⁹ Willis Towers Watson, *Global Pension Assets Study 2017*. Available at www.willistowerswatson.com/en/insights/2017/01/global-pensions-asset-study-2017.

²⁰ PricewaterhouseCoopers, "The rising attractiveness of alternative asset classes for sovereign wealth funds" (2018). Available at: www.pwc.lu/en/alternative-investments/docs/pwc-sovereign-wealth-funds.pdf.

²¹ PricewaterhouseCoopers, "Asset and wealth management insights: Asset management 2020: taking stock" (2017). Available at www.pwc.com/gx/en/asset-management/asset-management-insights/assets/am-insights-june-2017.pdf.

²² Working Group on Financing for Sustainable Development, "Challenges in raising private sector resources for financing sustainable development" (2014). Available at sustainabledevelopment.un.org/content/documents/2106UNTF%20Chapter%20III.pdf.

²³ Willis Towers Watson, *Global Pension Assets Study 2018*. Available at www.willistowerswatson.com/en/insights/2018/02/global-pension-assets-study-2018.

contracts and creating performance benchmarks could create liquidity and attract greater investment. This has to be done with great care, as creating liquid instruments on illiquid assets, such as infrastructure, without clearly specifying who is holding the liquidity risk could create short-term liquidity bubbles, leading to bankruptcies of projects when the bubbles burst. Indeed, most of the financial crises of the past two decades have been linked to markets' mispricing of liquidity. Further work is required to better understand associated risks.

26. The short-term orientation of capital markets is reflected not only in the volatility of cross-border capital flows, but also in the short average holding period of stocks in some developed markets, which has fallen from eight years in the 1960s to eight months today. This short-term outlook is a major impediment to increasing financing for sustainable development. Without a long-term investment horizon, certain risks, such as those from climate change, will not be incorporated into decision-making. Aligning the incentives of institutional investors in all countries with sustainable development would not only raise resources for the Sustainable Development Goals, but also contribute to the global public good of a stable international financial system.

27. In source countries, Governments can explore ways to incentivize institutional investors to take a long-term approach, such as by reviewing regulatory frameworks and encouraging longer-term horizons in indices and credit analysis, including in ratings. Destination countries can adopt capital account management techniques, including macroprudential regulations, that have proven effective in shifting the maturity profile of investment.

Restoring debt sustainability

28. The increasing concerns about debt sustainability in a number of developing countries underscores the importance of ensuring that the international system can address sovereign debt distress. Sovereign debt crises often lead to a spiral of capital flight, rising interest rates and unemployment. Even short of a crisis, high debt levels impede sovereign borrowing, hampering efforts to finance the Sustainable Development Goals.

29. Not all borrowing has the same long-term effect on debt sustainability. Productive investments in the Sustainable Development Goals, including in infrastructure, could spur growth and strengthen debt indicators. The Economic and Social Council, in its report on the forum on financing for development follow-up, recognized that it is helpful to differentiate how borrowing resources are used, and that effective public investment in infrastructure and productive capacity in support of the Goals, under appropriate public debt management, can have a positive impact on fiscal space and debt sustainability.²⁴

30. Although significant progress has been made in implementing market-based solutions to debt distress, such as the inclusion of collective action clauses in bond contracts, the process for sovereign debt restructuring remains fragmented and uncertain. Use of innovative instruments, such as State-contingent debt instruments that reduce or delay debt servicing payments in times of crisis, could lessen financial stresses and could be readily adopted by official sector lenders. These could be particularly useful for countries facing disasters.

31. While political consensus on how to implement a comprehensive, predictable, and equitable framework for effective and efficient sovereign debt restructuring does not exist, a number of forums have sought to develop principles and guidelines that, while not mandatory, could, through voluntary adoption, become standards. Indeed,

²⁴ E/FFDF/2018/3

the Addis Ababa Action Agenda committed Member States to work towards a global consensus on guidelines for debtor and creditor responsibilities in borrowing by and lending to sovereigns, building on existing initiatives, such as the UNCTAD Principles on Promoting Responsible Sovereign Lending and Borrowing.

B. International financial risks and regulation

32. To achieve the Sustainable Development Goals, the financial system should ultimately facilitate the flow of funds from savers to borrowers in a stable and sustainable manner and effectively allocate funds throughout the economy. The 2008 world financial and economic crisis made it abundantly clear that regulatory frameworks were insufficient to address systemic risks in the financial system. A significant portion of the financial sector had exposure to assets that were much riskier than most financial sector analysts or regulators understood.

33. At present, almost a decade after financial regulatory reform was initiated, policy development for the agenda endorsed by the Group of 20 is largely complete, although full implementation of the new standards is still pending. As the 2008 financial crisis recedes into history, there is already pressure to roll back some of the reforms, and it is unclear if there is sufficient political will to take additional steps to tackle systemic risks that were not adequately addressed by the agreed reform agenda. Meanwhile, only a few steps, for instance on climate-related financial disclosures, have been taken to align the regulatory system with the Sustainable Development Goals.

Banking and insurance regulation

34. Robust regulatory frameworks are essential for the stability of the international financial system. Banking regulations aim to ensure that commercial banks hold sufficient capital and liquidity to cover potential losses in their portfolios, and are thus able to withstand financial and economic stress. Various complementary requirements have been agreed by the Basel Committee on Banking Supervision since 2009, including boosting banks' capital, ensuring that banks have sufficient high-quality liquid assets and requiring banks to maintain a sustainable funding profile.

35. While much has been done in terms of banking regulation, the impact of the reforms on sustainable development remains unclear. Regulations create incentives, including regarding the allocation of capital, with potential unintended consequences for access to credit to finance the Sustainable Development Goals, such as trade finance and long-term financing for infrastructure. Indeed, the final standards adopted by the Basel Committee on Banking Supervision in December 2017 lowered the risk-weight for loans to small and medium-sized enterprises from 100 to 85 per cent, in recognition of the important role they play in generating growth and jobs and contributing to sustainable development. To help to reduce discrepancies between the different risk methodologies used by small and large financial institutions, the Committee also determined, after much discussion, that banks using internal risk models for setting minimum capital buffers could not have risk-weighted capital more than 27.5 per cent below what would be required if they used the standardized approach for risk weighting, although the size of the floor was subject to considerable debate.²⁵

36. Reforms to address the problem of too-big-to-fail financial institutions were also further developed, but additional work is required to build effective resolution regimes for such institutions and operationalize resolution plans for cross-border firms.

²⁵ <https://www.bis.org/press/p171207.htm>

37. The Financial Stability Board is currently conducting evaluations of the effects of reforms on the financing of infrastructure investment and other areas. To date, there has been limited evidence of impacts. Total cross-border bank claims on developing countries reported to the Bank for International Settlements have continued to grow since early 2015, although the share of long-term claims has decreased and trends vary across countries. Some emerging markets and developing economies continue to report concerns about the reduction in activity by global banks in their domestic markets, although to date this decline does not seem to have had a significant impact on their overall credit growth.

38. Policymakers have an interest in ensuring that the financial system is resilient to all forms of risk. Disclosure of material climate-related financial information is a prerequisite for financial firms to manage and price climate risks appropriately. The Task Force on Climate-related Financial Disclosures published recommendations for voluntary climate-related financial disclosures in June 2017. To date, more than 240 companies holding a combined market capitalization of over €5.1 trillion have indicated support. Nonetheless, there are still calls for mandatory reporting. This progress on climate disclosures could serve as a template for similar disclosures on other aspects of the Sustainable Development Goals.

Shadow banking and derivatives

39. Shadow banking, which falls outside the regulatory framework for commercial banks, and derivative products can still pose systemic risks to the global economy. A narrow measure of shadow banking that includes non-bank financial entities that may pose financial stability risks reached \$45.2 trillion in 2016, an expansion of 7.6 per cent over 2015. A broader measure comprising other non-bank financial intermediaries grew 8 per cent to \$99.2 trillion in 2016.²⁶ The aspects of shadow banking generally considered to have contributed the most to the 2008 world economic and financial crisis have declined significantly and are considered by the Financial Stability Board to generally no longer pose financial stability risks.²⁷ However, as at June 2017, 14 Financial Stability Board jurisdictions were behind schedule in the implementation of at least one area of shadow banking reform,²⁸ and in some areas there are questions about whether the reforms are strong enough. For example, assets held in collective investment vehicles that are susceptible to runs (such as open-ended fixed income funds, credit hedge funds, real estate funds and money market funds) remain large or have grown by around 13 per cent a year since the crisis.²⁹ The considerable growth has been accompanied by a relatively higher degree of credit investment as well as greater liquidity and maturity risks.

40. Implementation of the reforms agreed by the Financial Stability Board with regard to over-the-counter derivatives is now well advanced, although this has taken longer than originally intended owing to the scale and complexity of the reforms and other challenges. Central clearing is simplifying much of the previously complex, opaque web of derivatives exposures, and is prevalent in interest rate derivatives and to a lesser extent in credit default swaps, but still rare in foreign currency derivative

²⁶ Excludes insurance companies, pension funds and public finance institutions. See Financial Stability Board, *Global Shadow Banking Monitoring Report 2017* (2018). Available at www.fsb.org/wp-content/uploads/P050318-1.pdf.

²⁷ Financial Stability Board, "Assessment of shadow banking activities, risks and the adequacy of post-crisis policy tools to address financial stability concerns" (2017). Available at <http://www.fsb.org/wp-content/uploads/P300617-1.pdf>.

²⁸ Financial Stability Board, *Implementation and effects of the G20 financial regulatory reforms: third annual report* (2017). Available at <http://www.fsb.org/wp-content/uploads/P030717-2.pdf>.

²⁹ Financial Stability Board, *Global Shadow Banking Monitoring Report 2017* (2018). Available at www.fsb.org/wp-content/uploads/P050318-1.pdf.

contracts.³⁰ More collateral is in place to reduce counterparty credit risks within the system. Progress has also been made in improving transparency of derivatives transactions, but recent analysis has suggested that cross-border arbitrage has undermined the ability of the regulators of the banking groups that have subsidiaries dealing in derivatives to fully understand the derivatives-related exposure and leverage of the banking groups, many of which are considered systemically important.³¹

Financial inclusion and correspondent banking

41. There is a growing body of evidence that more inclusive financial markets, including for small and medium-sized enterprises, support economic growth and employment, and reduce inequalities. The updated Global Findex database, released in May 2018, shows that globally 69 per cent of adults now have a financial account, up from 62 per cent in 2014. There are, however, wide variations. In some countries, less than 10 per cent of the population have financial accounts, versus over 90 per cent in other countries. As of 2017, 72 per cent of men, but only 65 per cent of women, have an account. No progress has been made on closing the 7 percentage point gender gap over the past six years. Technological solutions are advancing: in developing economies, 19 per cent of adults reported making at least one direct payment using a mobile money account, a mobile phone or the Internet, with sub-Saharan Africa remaining the global leader in the use of mobile money.³² The increasing digitalization of finance raises the importance of enhancing financial and digital literacy, in order to protect consumers from exploitative financial practices, and strengthening consumer protection.

42. Surveys indicate that lack of finance is a major obstacle for small and medium-sized enterprises in many developing countries. Structural transformation strategies often aim to build a core of small and medium-sized enterprises interconnected with larger enterprises capable of promoting industrial upgrading. As noted above, regulation impacts incentives, and may have unintended consequences on lending to small and medium-sized enterprises. Policies intended to improve the capacity of small and medium-sized enterprises to secure affordable finance include awareness programmes to inform owners and managers of all available financing options. Some countries have put initiatives in place to improve investor readiness, including accelerators or incubators that provide start-ups and small and medium-sized enterprises with training.

43. Some parts of the international financial system rely on correspondent banking relationships, which are agreements between two banks in different countries to handle transactions on behalf of each other. These enable the provision of domestic and cross-border payments, and are critical for trade finance and facilitating the transfer of remittances from migrant workers. However, the number of correspondent banking relationships has continued to decline, with the number of active relationships falling 8 per cent across all currencies from 2011 to mid-2017. While the average number of active corridors per country increased for North America and Eastern Europe, all other regions, including Africa, Asia, Latin America and the Caribbean, recorded declines.³³

44. The causes of these declines are multiple, and likely include the costs of complying with anti-money laundering and know-your-customer rules and the desire of banks to reduce their risks. This may have an impact on the ability to send and

³⁰ www.bis.org/publ/otc_hy1805.htm

³¹ www.ineteconomics.org/research/research-papers/too-big-to-fail-banks-regulatory-alchemy

³² globalfindex.worldbank.org

³³ Financial Stability Board, *Correspondent Banking Data Report* (2018). Available at www.fsb.org/wp-content/uploads/P060318.pdf

receive international payments, or may drive some payment flows underground, with potential adverse consequences for international trade, growth, remittances and financial inclusion, as well as the stability and integrity of the financial system.

45. Regulations, capacity-building, strengthened tools for due diligence³⁴ and greater use of financial technology can help to address the decline in correspondent banking relationships. In the past year, the Financial Action Task Force discussed progress on revised guidance to help clarify regulatory expectations, while the Wolfsberg Group of Banks, whose members include major global correspondent banks, published a questionnaire designed to standardize the information needed to make know-your-customer utilities function more efficiently. Using technology to improve the exchange of standardized customer information by international banks and the know-your-customer utilities can reduce the cost and risk of operating correspondent banking relationships.

Credit rating agencies

46. Credit rating agencies play an important role in the functioning of capital markets and influence the flow of finance towards countries, companies and projects. With the three largest credit rating agencies still holding a 95 per cent share of business in the largest financial markets, there remain concerns about competition and oligopolistic practices. The financial crisis demonstrated that inaccurate ratings can impact the stability of the international financial system. Ratings also tend to be pro-cyclical, rising during economic upturns and falling during downturns, pushing up the cost of borrowing during a downturn when firms may need financing most. National monitoring of the adherence of credit rating agencies to regulations continues, with a recent United States report finding that in some instances agencies did not properly apply or adhere to their own methodologies and policies for determining ratings, and that some agencies did not have sufficient procedures to prevent potential conflicts of interest arising from their business activities.³⁵ In addition, the time horizon for ratings is relatively short — between two to five years for corporate debt — which helps to institutionalize shorter-term outlooks.

47. On the positive side, credit rating agencies are increasingly factoring into their analysis environmental, social and economic risks that have a material impact on financial returns, although this is not yet systematic. In the autumn of 2017, the three major credit rating agencies provided more detailed information on how they incorporate environmental, social and governance factors into their ratings. Standard & Poor's performed an analysis of ratings changes and found that over a two-year period, environmental and climate concerns featured in the analysis of 717 corporate ratings, and that in 106 of those cases, such concerns were material to credit quality and resulted in changes in ratings.³⁶ A longer-term outlook would likely increase the impact of sustainability considerations on performance, since many environmental and social risks are relevant only on time horizons longer than five years. Rating agencies could, as a first step, publish longer-term ratings alongside traditional ratings.

³⁴ Financial Stability Board, "FSB action plan to assess and address the decline in correspondent banking: Progress report to G20 finance ministers and central bank governors" (2018). Available at <http://www.fsb.org/wp-content/uploads/P160318-2.pdf>

³⁵ United States Securities and Exchange Commission, *2017 Summary report of Commission staff's examinations of each nationally recognized statistical rating organization* (2017). Available at www.sec.gov/oet/reports-and-publications/special-studies/nrsro-summary-report-2017.pdf

³⁶ www.spglobal.com/our-insights/How-Does-SP-Global-Ratings-Incorporate-Environmental-Social-and-Governance-Risks-Into-its-Ratings-Analysis.html

Emerging trends and challenges

48. Digitalization of finance could enhance economic data collection and support early warning systems and better preparedness. Digitalization can help the financial system to reach populations without access to financial services, including women. Mobile money services have grown into major payments providers, with over 6 billion transactions annually. Technology-enabled sharing of information can strengthen credit analysis, thus increasing access to credit for small and medium-sized enterprises. Financial technology has the potential to lower the cost of remittances, and innovative applications can help to address the decline in correspondent banking relationships. However, there are risks associated with digital finance. Many new actors and products are not currently covered by regulatory frameworks. If not appropriately regulated, they can pose risks to customers. While consumer protection is particularly important when customers have relatively low financial and digital literacy, it is critical in all contexts given the continually changing nature of technology and asymmetric access to information. Effective financial regulation can also support competition, impede monopolistic behaviour and address privacy-related issues.¹⁷

49. Regulation will also need to consider the impact of virtual currencies, also called cryptoassets. The anonymity and cross-border reach of virtual currencies raise concerns around illicit finance.¹⁸ Transactions cannot be authoritatively traced to real identities owing to anonymizing service providers, meaning that virtual currencies can conceal or disguise the illicit origin, use or transfer of funds. The Financial Action Task Force has called for the regulation of virtual currency exchanges to reduce risk. In 2017, several Asian countries that host virtual currency exchanges introduced new regulations or announced their intention to do so. With the blurring of boundaries among entities, activities and jurisdictions, new common standards and legal principles may be warranted to ensure that digitalized finance aligns with national and international priorities.

C. International public finance institutions

50. Development banks have a key role to play in financing the 2030 Agenda, as recognized in the Addis Ababa Action Agenda. Development banks — multilateral, subregional and national — fund public goods and other investments that are in the public interest but that are not commercially feasible. They can also act countercyclically to provide resources in times of market stress. Efforts to align public finance institutions' operations with the Sustainable Development Goals are further advanced than efforts on private investment, although there is scope for improvement.

51. The Addis Ababa Action Agenda called upon multilateral development banks to make optimal use of their resources and balance sheets, consistent with maintaining their financial integrity. Since 2015, the World Bank, the Asian Development Bank, the African Development Bank and the Islamic Development Bank have taken steps to make better use of their balance sheets by allowing leverage on grant resources, undertaking balance sheet mergers, securitizing or selling loans after origination, cutting expenditure, increasing fees, enhancing risk management and diversifying

¹⁷ Financial Stability Board, "Financial stability implications from fintech: supervisory and regulatory issues that merit authorities' attention" (2017). Available at <http://www.fsb.org/wp-content/uploads/R270617.pdf>

¹⁸ Dong He and others, "Virtual currencies and beyond: initial considerations" (2016). IMF Staff Discussion Note SDN/16/03. Available at www.imf.org/external/pubs/ft/sdn/2016/sdn1603.pdf

risk exposures. Some multilateral development banks are also increasing lending relative to equity while seeking to maintain their credit ratings.

52. In addition, several national development banks operate internationally. Most notably, new banks are being established in Canada and have been proposed in the United States, while others, such as the Commonwealth Development Corporation in the United Kingdom of Great Britain and Northern Ireland, are getting capital infusions. In terms of size, the Brazilian National Bank for Economic and Social Development and the Chinese policy banks, the China Development Bank and the Export-Import Bank of China, remain the largest.

53. While multilateral development banks are aligning their strategies with the 2030 Agenda, to achieve the Sustainable Development Goals they will need to achieve greater scale and ensure that social and environmental sustainability impacts are embedded in their lending, in particular for infrastructure investments that will lock in development paths until 2030 and beyond. This could include further aligning internal staff incentives with metrics relevant to achieving the Goals, rather than primarily with lending volumes. This will require careful monitoring and evaluation, built on effective measurement of sustainable development impact.

54. Monitoring, evaluation and measurement are particularly important for blended finance projects, as the inclusion of profit-seeking private resources make it incumbent on the public partners to ensure that projects are contributing to national sustainable development priorities. The International Finance Corporation is in the process of developing a new impact measurement methodology to replace its Development Outcome Tracking System. The new methodology, the Anticipated Impact Measurement and Monitoring system, began with pilots in July 2017 and is expected to be rolled out more broadly in 2018. The International Finance Corporation intends to reward its staff financially for projects that achieve development impact above a minimum performance floor.

55. The Addis Ababa Action Agenda also stresses that development banks should establish or maintain environmental and social safeguards systems, including on human rights, gender equality and women's empowerment, that are transparent, effective, efficient and time-sensitive. In this regard, the World Bank's new Environmental and Social Framework, adopted in 2016, will be applied to projects from October 2018, although questions remain regarding how its application will be monitored.³⁹

56. Member States continue to emphasize the importance of women's rights and gender equality, and encourage international financial institutions to include gender equality in their investment decisions. Multilateral development banks, for the most part, are improving the gender sensitivity and gender impact of their lending. For the World Bank Group as a whole, gender targets are being met. The share of World Bank Group projects that were gender-informed rose from 62 per cent in 2016 to 71 per cent in 2017, above the target. However, there is still room for improvement. For example, in the fiscal year 2017 only 29 per cent of the International Finance Corporation's nominees for positions on the boards of directors of its clients were women.

³⁹ www.hrw.org/news/2017/12/04/letter-world-bank-environmental-and-social-standards-guidance-notes.

D. Other international economic issues⁴⁰

Illicit financial flows

57. Illicit financial flows represent a major obstacle to efforts to mobilize domestic resources for sustainable development. Illicit financial flows are generally related to transnational crime, corruption or abusive tax practices, although these categories are not mutually exclusive or comprehensive. Different components of illicit financial flows are not directly comparable and aggregation of estimates across channels and components could result in double counting.

58. While estimating illicit offshore wealth holding is difficult because of the secrecy afforded in many jurisdictions, new data are improving the accuracy of estimates. One study estimates that, as at October 2017, 10 per cent of world gross product is held as private offshore financial wealth.⁴¹ However, there are currently insufficient data to determine what volume of this wealth is being disclosed correctly to tax authorities.

59. In 2017, the joint custodian agencies of Sustainable Development Goal indicator 16.4.1 on illicit financial flows — the United Nations Office on Drugs and Crime and UNCTAD — began to develop, review and test a statistical methodology to estimate the volume of illicit financial flows. Testing of the proposed statistical methodologies will take place in Latin America and Africa beginning in 2018.

60. Tackling illicit financial flows will require strengthening existing institutions and greater enforcement of current laws, as well as the development of new policies and practices. The innovative use of new technologies may also be helpful. Many of the tax transparency reforms being put forward by the Group of 20 and introduced internationally will be relevant for tracking and stopping illicit financial flows. In particular, strengthened beneficial ownership registries and mechanisms to share that information will be critical to penetrating the trusts, shell corporations and other financial vehicles used to hide illicit financial flows and their resulting assets, while automatic exchange of financial account information seeks to incentivize the disclosure of offshore financial wealth. Country-by-country reporting from transnational corporations can help to expose and reduce tax evasion. While considerable progress has been made by OECD and the Group of 20 regarding some aspects of illicit financial flows, lower-income countries, which often do not have sufficient capacities and institutional frameworks, are generally excluded from the solutions. The Addis Ababa Action Agenda emphasizes that efforts in international tax cooperation should be universal in approach and scope and should fully take into account the different needs and capacities of all countries.

Women's participation in the economy

61. Member States have repeatedly emphasized that women's equal access to and opportunities for participation and leadership in the economy are crucial to the realization of women's human rights and sustainable development. Approximately one third of the world's formal sector enterprises are owned and operated by women, but enterprise survey data are only updated in a handful of countries each year, making global trends difficult to detect. Women entrepreneurs tend to experience far more difficulties than men in starting and expanding their businesses, which can be

⁴⁰ Several additional areas of concern that Member States identified in General Assembly resolution 72/203 are grouped under this heading.

⁴¹ Annette Alstadsæter, Niels Johannesen and Gabriel Zucman, "Who owns the wealth in tax havens? Macro evidence and implications for global inequality", National Bureau of Economic Research Working Paper No. 23772 (September 2017).

linked to laws that have a differential impact on men and women, for example with regard to land ownership and inheritance, as well as cultural norms and social attitudes. In 2017, women held 17.3 per cent of seats on corporate boards globally, up from 15.8 per cent in 2016, with gains in both developed and developing countries.⁴² The International Labour Organization has found little change in the likelihood that women are classified as "employers". Female employers account for only 1.7 per cent of total female employment, compared to 4 per cent among men.⁴³ A major contributing factor to gender inequality in labour force participation is the unequal distribution of unpaid work between women and men, with women's time spent on unpaid domestic work and caregiving at home almost triple that of men, according to survey data from 83 countries and areas.⁴⁴

International investment agreements

62. While foreign direct investment remains a more stable form of cross-border financial flows, international investment agreements, which are meant to support foreign investment, often result in unintended consequences, such as constraining regulations that support sustainable development when the regulations impact investor profits. Some countries have become vulnerable to large financial penalties from arbitration panels set up to settle investor-State disputes, impeding their ability to implement policies in support of the Sustainable Development Goals. Investment treaty-making has now reached a turning point. The year 2017 saw the lowest number of new international investment agreements since 1983, signalling a period of reflection on and review of international investment policies. For the first time, the number of effective treaty terminations outpaced the number of new international investment agreements concluded.⁴⁵

63. Global progress on international investment agreement reform was reviewed at the annual high-level conference on international investment agreements organized by UNCTAD, which took place in October 2017. Highlights of modern treaty-making include a sustainable development orientation, preservation of regulatory space and improvements to or omissions of investor-State dispute settlement. As Member States reform outdated international investment agreements, policymakers and negotiators should carefully consider formulating comprehensive international investment agreement policies aligned with their national development strategies. This coherence should extend into a new phase of reform to address the coherence of international investment agreements with other legal frameworks, including both domestic law and international legal frameworks, such as commitments under the World Trade Organization or double taxation treaties. As private investors increase their investment in the Sustainable Development Goals, it is imperative that the underpinning legal environment is supportive of sustainable development.

E. Governance reform

64. The Addis Ababa Action Agenda emphasizes the importance of coherent and consistent international financial and monetary and trading systems in support of development. To achieve the Sustainable Development Goals, Member States must

⁴² MSCI, *Women on boards: progress report 2017* (2017). Available at www.msci.com/www/research-paper/women-on-boards-progress-report/0806530251.

⁴³ International Labour Organization, *World Employment Social Outlook: Trends for Women 2018* (Geneva, 2018).

⁴⁴ Global SDG Indicators Database.

⁴⁵ UNCTAD, *World Investment Report 2018: Investment and New Industrial Policies* (Geneva, 2018).

not only increase financing, but also put in place fit-for-purpose national and international institutions.

65. In the Addis Ababa Action Agenda, the Heads of State and Government and High Representatives recommitted themselves to broadening and strengthening the voice and participation of developing countries in international economic decision-making. They also reiterated their commitment to further governance reform in both IMF and the World Bank. In April 2018, World Bank shareholders came to an agreement on reforms to the Bank's voting rights, which is expected to be formally adopted in October 2018. The package of reforms includes a selective capital increase and efforts to better leverage the Bank's balance sheet. The reforms are expected to see the voting power of countries in developing regions at the Bank's non-concessional lending arm grow from 39.7 per cent to 40.5 per cent, with the largest gains for Asian countries, which stand to see their voting rights increase from 29.2 per cent to 30.2 per cent. China will see its voting rights increase from 4.4 per cent to 5.7 per cent. Similar changes are expected at the International Finance Corporation, with developing countries moving from 35.7 per cent of voting rights to 36.5 per cent of voting rights.

66. The IMF Board of Governors agreed in December 2016 to work towards completing the fifteenth General Review of Quotas, including a new quota formula, by the 2019 Spring Meetings and no later than the 2019 Annual Meetings. The Executive Board submitted progress reports on the fifteenth General Review to the IMF Board of Governors in October 2017 and April 2018.

67. To address impediments to further reform of global institutions, in April 2017 the Group of 20 established an Eminent Persons Group on Global Financial Governance, which will conduct a high-level review of the challenges and opportunities facing the international monetary system and global financial governance, including mandates, coherence, transparency and accountability of international financial institutions. The recommendations of the Eminent Persons Group overlap with many of the issues discussed in the present report.

68. The Eminent Persons Group published updates in 2017 and 2018, referencing implementation of the 2030 Agenda as a motivation. The first update highlighted an irreversible trend towards multipolarity and an environment of constrained public balance sheets, crisis legacies and challenging domestic socioeconomic realities, with diminished trust in institutions.⁴⁶ The second update suggested that the multilateral development banks should increase collaboration among themselves and place a greater focus on achieving development impact. It also recognized that there is no internationally agreed framework for assessing and mitigating excessive volatility of capital flows and exchange rates, and made recommendations for strengthening the global financial safety net and financial surveillance. The Eminent Persons Group called for greater clarity regarding the division of responsibilities among the United Nations, international financial institutions and other actors in relation to addressing global challenges, but did not specify any division of labour. It also suggested that the Group of 20 should remain the driving force of global governance through the setting of multi-year strategic agendas, despite the fact that it does not have universal membership and is not legally constituted to deliver on decisions.⁴⁷ The Eminent Persons Group will present its final conclusions in October 2018.

⁴⁶ www.bundesfinanzministerium.de/Content/EN/Downloads/G20-Wash-okt-International-Financial-Architecture.pdf?__blob=publicationFile&v=1.

⁴⁷ g20.org/sites/default/files/media/epg_chairs_update_for_the_g20_fmcgbs_meeting_in_buenos_aires_march_2018.pdf.

IV. Conclusions

69. Strengthened international cooperation is critical to ensuring a stable and sustainable financial system. Achieving the Sustainable Development Goals will require financial stability and sustainability. There is a clear and pressing need to reorient the financial system, through policies and regulation, to support the broader aims of financing sustainable development in a stable manner.

70. Developing countries remain exposed to sudden changes in financial market sentiment and the volatility of private flows. Nationally, sound macroeconomic policies oriented towards achieving the Sustainable Development Goals need to be complemented by effective financial regulation, macroprudential measures and capital account management. Measures to better align financial markets with long-term sustainable investment can also reduce the volatility of capital flows.

71. National policies need to be supported by an international enabling environment. International cooperation is essential in order to reform the international monetary system and the global financial safety net, as well as to better align international public finance institutions with the Sustainable Development Goals. Greater macroeconomic policy coordination will be especially important as the world moves by default to a multicurrency reserve system.

72. The implementation, supervision and enforcement of other regulatory initiatives remain crucial. Such initiatives include work to align reporting and accounting standards and credit ratings with sustainable development, using progress in the area of climate to inform other efforts.

73. Member States have recognized that reforming the financial system is necessary but not sufficient; additional areas for action include the fight against illicit financial flows, the reform of international investment agreements, and women's empowerment and the mainstreaming of gender equality.

74. Ultimately, global economic governance structures should evolve to be fit for a new era. Creating more equitable governance arrangements and using the relevant forums provided by the United Nations for international economic decision-making will help to advance efforts to align the international financial system with the 2030 Agenda.